Introduction

With few exceptions, the investment securities of a bank constitute a significant percentage of its total resources. Management's decisions in this area will obviously impact the ratings assigned to capital adequacy, asset quality, management, earnings, and liquidity and funds management. Examiners must review and appraise a bank's investment policies, evaluate its established procedures and recognize efficient and deficient practices. The UBPR quantifies portfolio mix, yield, maturities, etc., in convenient formats which demonstrate the impact of past investment decisions and economic conditions, and can serve as a guide in examining a particular securities account. Subjects discussed herein are frequently presented in a broad and guiding manner rather than a specific and procedural one, in the hope examination procedures and methods will be tailored to the particular requirements and circumstances of the bank being examined. Uniform Agreements, Policy Statements, News Releases, Regional Office Memorandums, Reporting Instructions and other Corporation objectives and policies are referenced as appropriate.

I. INVESTMENT POLICIES

Management of a bank's securities portfolio, as well as other money market investments, necessitates adoption of a definite investment policy. Its development and formulation is the responsibility of directors and senior executive officers. The principal objective of a well-defined policy is to furnish guidance in maintaining an investment portfolio which, along with other sound assets, provides earnings and sufficient liquidity to ensure a reasonable degree of flexibility in a bank's operations. However, to ensure that directors do not delegate policy decisions, a bank's investment policy must provide details and encompass minimums and maximums rather than a philosophical description of objectives. The policy should be in written form, except in very simplistic situations, reviewed periodically by the board and revised in light of the changing circumstances and needs of the bank. It should also detail standards for selection that thoroughly consider Quality, Maturity, Diversification, Marketability, and Income.

Quality

Issues of securities that may be lawfully acquired by banks vary greatly with respect to investment quality. However, the supply of bank investment grade issues is more than sufficient to satisfy all portfolio requirements. Typically, the structure of liabilities and the narrowness of capital margins are such that banks are not able to assume the risks of loss arising from commitments in marginal or low quality issues. Banks sometimes acquire marginal grade or subinvestment securities because of the desire to finance a borrower, e.g., a municipality or school district in its service area. In such instances, the aggregate holdings should be reasonable relative to the condition of the bank involved. More often such commitments are the result of inadequate credit analysis or represent an ill-advised effort to increase earnings by acquiring high yielding securities at the sacrifice of quality standards. Quality, however, is not the only consideration. For example, a high quality issue may be inappropriate for a bank portfolio because its maturity is too long, its purchase may result in a lack of diversification, or it may lack marketability.

Maturity

The maturity pattern appropriate for any bank will depend upon individual circumstances. Examiners should avoid adoption of any dogmatic rule or formula for application to all banks. A soundly planned maturity schedule will take the following circumstances into consideration: the bank's invested position; prevailing and anticipated loan demand; stability and mix of funding sources; and seasonal and secular trends of the community the bank serves.

A prudent and successful investment policy can accommodate a wide range of maturities, including limited holdings of long-term issues. However, investment in long-term issues, other considerations aside, amounts to a judgment that investment terms will not become more favorable over the life of the investment or that the yield on the investment will at least equal the average yield of alternative investments available during the period it is held. This is a difficult, if not impossible, judgment to make and one that carries significant risks, for prices of such securities fluctuate more widely in the market as a result of major movements in the level of interest rates.

Diversification

Proper diversification in an investment portfolio will avoid unfavorable investment concentrations in obligations of a single issuer or in securities the credit of which depends largely upon the same set of factors or circumstances. Excessive diversification, however, may create managerial problems. When a portfolio is composed of a multitude of different issues, it becomes difficult for management to maintain the necessary familiarity.

Marketability

This is an essential requirement for a substantial part of the investment account. Accordingly, concentrations in obscure issues, either municipal or corporate, are undesirable. Whatever their quality or other merits, such holdings may be hard to sell when cash is needed and even unsuitable for rediscounting or as collateral for loans from correspondent banks. Marketability alone does not make a security suitable for bank investment. For example, defaulted issues might be readily marketable and subject to frequent quotations, while obligations of small enterprises and political subdivisions which have rather high credit quality may never be quoted in a recognized source of price data. The latter issues, however, should not be deemed unsuited for bank investment for that reason alone. Examiners must appraise them on the basis of their intrinsic credit quality, and a reasonable investment in such issues will not properly be the subject of criticism.

Income

Securities are purchased to produce income, but no bank should become so obsessed with income that it loses sight of the safety factors of quality, maturity, diversification, and marketability. High risks usually accompany high yields relative to the then current interest rate cycle and unusually high yields should arouse suspicion. At the same time, not all securities of equal quality provide the same yield, and competent portfolio management can improve income by prudent choice among alternatives of similar quality.

An important and complex consideration in choosing the types of securities for investment is the relevance of tax considerations. Income from obligations of states and their political subdivisions ("municipals") purchased prior to 1987 is at least partially exempt from Federal income tax, and these securities also enjoy certain other tax advantages in many states. However, the Tax Reform Act of 1986 provided that, subject to a limited exception, interest expense on funds used to carry tax-exempt obligations acquired after August 7, 1986, cannot be deducted for taxable years beginning after December 31, 1986. The attractiveness of acquiring these types of securities has been greatly reduced inasmuch as prospective purchasers will not be acquiring the same tax benefit as in years prior to 1987.

II. FACTORS TO BE CONSIDERED IN APPRAISING AN INVESTMENT POLICY

In appraising and discussing the selection standards set by an "investment policy", the examiner must consider the following matters.

General Character of the Institution's Business

A thorough study of the type of business conducted by a bank is needed to determine credit requirements of customers and the degree of stability in deposit accounts. A bank serving an agricultural area or a single-industry community is likely to experience greater fluctuations in deposit volume than one operating in a community with a well-diversified economic base. If correspondent banks, large corporations, or public funds account for a substantial portion of a bank's deposits, a more liquid condition normally would be needed than if deposits are chiefly moderate-sized accounts of individual and business enterprises. The character and maturities of a bank's loan portfolio are also important. It is essential for the investment policy to take into consideration seasonal variations and long-term trends in the demand for loans.

Analysis of Funding Sources

Trends in the total volume of deposits and other sources of funding as well as changes in the composition of accounts are important factors to be considered in judging a bank's investment policy. The accounts should be analyzed with respect to source (individual, business, public, banks, etc.) and degree of permanence, for example, demand or time accounts. A study of account balances by size may reveal abnormal and excessive balances of particular customers, an unusually large volume of public funds, and other special accounts that may become particularly vulnerable. Analysis of large denomination certificates of deposit outstanding and their maturity pattern would be particularly significant.

Capital Funds

A bank's capital funds provide the margin to absorb losses that may be sustained in all of its operations, including its investment activities. While the total capital accounts are available to absorb losses, a bank may be obliged, as a practical matter, to suspend operations or reorganize if its losses impair capital stock (and in some cases certain other capital segregations). Accordingly, the investment policy of a bank will depend to some extent upon the availability of the capital cushion to absorb losses that may be sustained from commitments in certain classes of securities. Generally speaking, the smaller the capital cushion the greater the need for caution in the selection of investments.

Economic and Monetary Factors

It is quite possible for any intelligent observer to ascertain a few basic facts about the prevailing economic climate, such as whether business conditions are expanding, stagnant, contracting or depressed. Study of graphic material will show whether money rates are relatively high or low and whether the financial structure of the economy is expanding or shrinking. Intelligent portfolio management will give consideration to these basic factors in formulating and executing investment policies. Undue preoccupation with these considerations, however, may be indicative of speculative tendencies.

III. PORTFOLIO MANAGEMENT

Sound portfolio management dictates that procedures be established and followed relative to analysis prior to purchase, execution of purchase and sales transactions, periodic monitoring of the portfolio, and maintenance of portfolio documentation.

Delegated Authority to Handle Securities Transactions

It is the responsibility of the directorate to fix and delegate formal authority to purchase and sell investment quality securities. This authority is normally delegated to the bank's chief executive officer, senior investment officers, or to an appointed investment committee.

Some depository institutions have delegated the purchase and sale authority for all or a portion of their investment securities portfolio to a non-affiliated firm or to an individual who is not an employee of the institution or one of its affiliates. When an institution has delegated such authority to a non-affiliated firm or to one or more individuals who are not employees of the depository institution or its affiliates, then the depository no longer has the ability to control its own securities, and all holdings for which such authority has been delegated must be reported as held for sale.

Delegating the authority to handle securities transactions does not relieve the board of directors of its responsibility to ensure that the bank's investment activities are conducted in a safe and sound manner.

The centralized management of investment portfolios of affiliated depository institutions by the parent holding company or another affiliate is not ordinarily considered to be the delegation of investment authority. Investment authority will also not be considered delegated when a depository institution's portfolio manager is required to authorize a recommended purchase or sale transaction prior to its execution and consistently makes such authorizations.

Recommendations Concerning the Selection of a Securities Dealer

Many financial institutions rely on the expertise and advice of a securities sales representative for recommendations concerning proposed investments and investment strategies and for the timing and pricing of securities transactions. Many of the investment problems experienced by financial institutions may have been avoided had sound procedures been followed before using certain securities dealers.

It is essential that the management of financial institutions have sufficient knowledge about the securities firms and personnel with whom they are doing business. A financial institution should not engage in securities transactions with any securities firm that is unwilling to provide complete and timely disclosure of its financial condition. Management should review the securities firm's financial statements and evaluate the firm's ability to honor its commitments before entering into transactions with the firm and periodically thereafter. An inquiry into the general reputation of the dealer also is necessary. The board of directors should develop a list of securities firms with whom management is authorized to do business. The board should also establish and periodically review dollar limits and limits on the types of transactions to be executed with each authorized securities firm. The list of approved securities firms and the board's established limits should be incorporated into the bank's written investment policy.

At a minimum, financial institutions should consider the following factors in selecting and retaining a securities firm:

1. The ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength, liquidity and operating results. This evidence should be gathered from current financial data, annual reports, credit reports, and other sources of financial information.

2. The dealer's general reputation for financial stability and fair and honest dealings with customers. Other financial institutions that have been or are currently customers of the dealer should be contacted.

3. Information available from State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer, its affiliates or associated personnel.

4. The background of the dealer's sales representative with whom business will be conducted to determine their expertise.

In addition, the board of directors (or an appropriate committee of the board) must determine that the financial institution has established appropriate procedures to obtain and maintain possession or control of securities purchased. In this regard, purchased securities and repurchase agreement collateral should only be left in safekeeping with selling dealers when (1) The board of directors is completely satisfied as to the creditworthiness of the securities dealer, and (2) the aggregate market value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors (or an appropriate committee of the board) for unsecured transactions (see the October 1985 FFIEC Policy Statement entitled "Repurchase Agreements of Depository Institutions with Securities Dealers and Others").

As part of the process of managing relationships with securities dealers, the board of directors should prohibit employees who are directly involved in purchasing and selling securities for the depository institution from engaging in personal securities transactions with the same securities firm used by the depository institution without specific board approval and periodic review. Appropriate policies applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel should also be adopted.

Periodic Review and Analysis of the Portfolio

The changing requirements placed upon an investment portfolio necessitate reasonably frequent review and comparison with planned investment goals. Special attention should be afforded to developing reports designed to reveal concentrations of investment risk; speculative, defaulted or otherwise undesirable securities; liquidity needs; and the bank's taxable earnings position. It is also desirable that current prices be obtained periodically on all securities to assess the relative degree of liquidity within the portfolio.

Portfolio Documentation

Credit Information - The extent and degree of credit file documentation and support should be sufficient to identify and measure accurately the quality of the securities held, and will vary in relation to the complexity and diversity within the portfolio. Where portfolio holdings are centered exclusively in obligations of the U.S. Treasury, Federal agencies, or other investment securities of recognized quality and merit, the need for extensive and detailed supporting files is materially diminished. On the other hand, if the portfolio includes obligations of limited or narrow market interest, such as non-rated municipal bonds or issues which do not have an established secondary market, it is essential that sufficient information be on file to assess the quality and risk of those issues. Attempts should be made to correct a failure to conform with these general standards, and any serious deficiencies in this area should be covered in the examination report.

Risk Analysis - Documentation of investment portfolio securities should not be limited solely to an assessment of credit risk. Rather, an institution's files should also contain information to support the analysis of interest rate risk. At a minimum, sensitivity analysis should be performed prior to purchase and periodically thereafter to demonstrate how cash flows and economic values of investment securities will react to various changes in interest rates. Disproportionately large holdings of securities with substantial interest rate risk should be criticized in the Interest Rate Risk Exposure Assessment schedule and, if appropriate, the Examination Conclusions and Comments Schedule.

The investment advisory services of correspondent banks, brokerage houses, or established rating services are valuable sources of information and their use is both proper and desirable. However, the ultimate responsibility for portfolio selection and supervision rests with the bank's management. The prudent discharge of those responsibilities depends upon the exercise of informed and independent judgment based on review and analysis of all the information essential to making those judgments.

IV. LIQUIDITY CONSIDERATIONS

Any discussion of investment portfolio management is incomplete without reference to the important function the securities portfolio plays in the management of the bank's liquidity position. A major objective of portfolio management is the avoidance of unintended and unforseen forced sale of securities at a capital loss. For this reason, many banks deliberately structure the maturity distribution of the securities portfolio to provide funds from maturing bonds over future years to meet estimated future needs with a reasonable margin of safety in the event of unexpected demands. Cash flow projections should be used to assist management in forecasting the institution's cash needs over future periods.

Within the banking industry, the terms primary reserves, secondary reserves, and investment account are frequently used in discussion of the securities portfolio in the context of liquidity. Since there is not a general agreement on precise definitions, these terms should be used with care to avoid misunderstandings.

Primary Reserves

For all practical purposes, primary reserves consist of cash and demand balances due from other banks. These assets generally comprise the major segment of the bank's legally required reserves (or statutory reserves). Although primary reserves (i.e., cash and demand balances due from banks) normally comprise a bank's most liquid assets, to the extent they represent all or part of a bank's "required" reserves and are held pursuant to statutory requirements, they do not provide the flexibility generally associated with liquidity reserves, except for very brief periods.

Secondary Reserves

As usually defined, secondary reserves consist of short-term readily marketable, unpledged securities and other negotiable instruments which can be converted into cash at little risk of loss. Other than such U.S. Government obligations, secondary reserves under most orthodox definitions will consist of bankers' acceptances, high quality open-market commercial paper, Federal funds, call loans to securities brokers and dealers, and other marketable obligations of like quality having a maturity not in excess of one year. In the aggregate, secondary reserves provide the most significant measure of a bank's liquidity.

Investment Account

In contrast to secondary reserves, whose chief purpose is to provide liquidity in anticipation of potential demands for funds, the primary objective of the bank's investment account is to produce maximum yield consistent with safety of principal (credit, market, and interest rate risk). Ideally, the investment account should be structured to carry accounts to maturity although as a practical matter, there are a number of situations in which it may be appropriate for a bank to sell securities in its investment account prior to maturity. Examples include to rid itself of an issue whose credit quality had declined, to obtain cash to meet unexpected loan demands or deposit withdrawals, to correct an unsatisfactory maturity distribution, to ameliorate a concentration of credit in obligations of one obligor or type, to take advantage of situations for taxation purposes, and otherwise provide more attractive opportunities for employment of funds. Investment portfolio securities that are not intended to be held to maturity should be designated as "held for sale" and carried at the lower of cost or market.

The operation of the investment account as a revolving fund, through appropriate spacing (laddering) of maturities, is one of the various investment policy strategies available which attempts to combine the objectives of income maximization and minimization of market risks. It is particularly suited to small or medium-sized banks, for it does not require sophisticated investment management expertise or recurring access to the financial markets, yet results in systematic or planned maturities which may be reinvested at current terms prevailing in the market or used for current needs. This regular roll-over of the investment portfolio enables a bank to realize a rate of return on its investment portfolio that should at least be equal to a moving average of prevailing yields during any given period. The maximum length of the maturity pattern for such a revolving fund investment program will vary from bank to bank, but ordinarily should be confined within a ten year range.

An investment policy of somewhat broader scope and flexibility may be followed successfully by banks that are knowledgeable as regards to day-to-day money market developments and have acquired expertise in the buying and selling of securities. Banks in these circumstances typically are large and, if they have adequate capital margins and reserves, can take advantage of opportunities for the profitable redeployment of funds in the investment account with a minimum of risk. Any investment program adopted, however, should provide enough flexibility to permit temporary deviations or substitutions during changing money market conditions.

V. ANALYSIS OF MUNICIPAL BONDS

In performing this task, the guidance furnished by published ratings of quality has limited application because recognized investment advisory services of necessity confine their coverage to relatively large issues of securities traded on a nationwide basis. Actually, there are thousands of small municipal flotations attractive primarily to local investors, and consequently these credits are not likely to come within the scope of any quality rating system. Such issues, however, often appear in bank portfolios, and the examiner is obliged to appraise their quality by analyzing the relevant credit data. The Securities Analysis Unit of the Division of Supervision regularly analyzes municipal credit data and prepares memorandums to aid examiners in the classification of securities on which information is not readily available.

Information should be available in a bank's own credit files or otherwise be readily accessible to bank management and examiners in sufficient detail to support a judgment that each issue in the portfolio is suitable for investment purposes. Much of this information is presented in manuals and summaries of credit data published by investment advisory services. Other sources include the offering circular or prospectus describing the issue at the time of flotation, periodic financial statements and audit reports, as well as material of a general nature pertaining to the economic status of the obligor.

The legal status of a municipal obligation is also a matter of vital importance in appraising credit quality. Accordingly, the bank's file should include information which answers questions as to the legality and validity of the obligation. The basis of this information is the legal opinion prepared by an expert in the field of municipal law stating that the issuance of securities complies with the applicable statutes and decisions, and that the obligation is legally enforceable in accordance with the specified terms. For an individual municipal credit, the legal opinion may be available as a separate document, in which case the bank should have a copy, or it may appear on the bond itself. Typically, the offering circular furnishes details regarding the legal status of the securities and identifies the municipal bond attorney responsible for the opinion.

To appraise the quality of municipal credit, the examiner requires sufficient information to judge the prospective investment performance of the obligor. With regard to insured tax-exempt securities, examiners should take into consideration the financial standing of the obligor as well as the quality of the insurance, especially if the presence of insurance is determined to make a subinvestment quality security an investment quality bond. This calls for an answer to the question, is there an adequate margin of protection to ensure that interest will be paid as it comes due and that the principal amount can be paid when the debt matures? In making this appraisal, the information needed and method of analysis depend upon the general nature of the bonds under consideration, as well as the spectrum of differences between issues which may extend over a very wide range. One major characteristic of general obligations of a municipality secured by a pledge of the full faith and credit of the issuer is a promise resting upon the unrestricted power to levy and collect taxes for the payment of debt service. Also, there are municipal obligations for which specific revenues are earmarked as a source of debt service, thus affording only a limited claim on the general taxing power of the issuer. A host of intermediate variations leads to municipal issues at the other end of the spectrum, namely, industrial revenue bonds. The latter do not provide the bondholder with a claim on the taxes or other revenues of the municipality issuing the securities. For such bonds, the issuer merely functions as a conduit for funds to service the debt, and creditworthiness can only be determined by appraising the financial standing of the enterprise that is the ultimate source of debt service.

Owing to the variations in the nature of the obligation that may be assumed by a municipality when securities are issued, as well as the factual differences between credits, it is not practical to design a standard list of data requirements for purposes of municipal bond analysis, nor can the methods of appraisal be reduced to a formula. But the objective of the examiner's appraisal remains the same in every case; i.e., to measure the adequacy of the margin of protection for debt service and to compare the results with the acceptable standards for bank investments.

VI. APPRAISAL AND CLASSIFICATION OF SECURITIES

The Uniform Agreement of the Classification of Assets and Appraisal of Securities Held by Banks covering the treatment of securities in bank examinations was first issued in 1938, revised in 1949, and reaffirmed and revised by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Conference of State Bank Supervisors on May 7, 1979. The Uniform Agreement, supplemented by various directives, assists the examiner in appraising and classifying securities in a reasonably uniform manner.

Essentially, the current Uniform Agreement provides (1) Definitions of "Substandard," Doubtful," and "Loss" classifications; (2) Definitions of Investment Quality and Subinvestment Quality securities; and (3) Specific guidance in the classification of subinvestment quality securities, including defaulted securities, not general obligations of a municipality; subinvestment quality securities, including defaulted securities, which are municipal general obligations; and subinvestment quality stock.

All Loss classifications of securities must be deducted in computing the institution's capital position, and these amounts should be eliminated from the institution's books. However, examiner requests for the charge off of a portion of securities classified Doubtful should only be made if the amount is significant, if prospects of the security ever attaining any real investment standing are extremely poor, and if the Regional Director approves the request.

In arriving at a determination of suitability of securities for bank investment and ultimately the appropriate classification, examiners will find the qualitative ratings provided by recognized investment advisory services to be helpful guides. Examiners should, therefore, become familiar with the various rating services and the qualitative standards implicit in their respective rating systems. However, ratings accorded by the investment advisory services should not be regarded as necessarily conclusive, and examiners should not feel constrained from deviating from the published ratings when the facts clearly and demonstrably support contrary findings. However, a strong case would necessarily have to be made in those instances where the recognized investment advisory services are unanimous in their qualitative evaluation. The ultimate and conclusive test of investment quality is actual credit soundness, and the principles underlying analysis and appraisal of credit soundness are essentially the same as those applicable to any credit instrument, bond or loan.

Investment Quality Securities

Investment quality securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating grades and unrated securities of equivalent quality. Neither market appreciation nor depreciation in these securities will be taken into account in computing net sound capital of the bank. This policy is intended to apply to recognized sound investment practices of banks and not to those situations where the portfolio requires special treatment. Exceptions would include overpayment and unwarranted write-ups (exclusive of discount accretion) and management's failure to properly amortize bond premiums. In those cases, Loss classification will be appropriate.

Subinvestment Quality Securities

Subinvestment quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes securities in grades below the four highest, unrated securities of equivalent quality and defaulted securities.

Securities in grades below the four highest and securities of equivalent quality will be appraised at market price and depreciation will be classified Doubtful; remaining book value classified Substandard. Depreciation in defaulted securities will generally be classified Loss and remaining book value classified Substandard.

An exception to the above will be made in the case of municipal general obligations backed by the credit and taxing power of the issuer. The entire book value of subinvestment quality municipal general obligations, which are not in default, will be classified Substandard. In the event of a default of a municipal general obligation, a period of time is usually necessary to permit the market for those defaulted securities to stabilize or for the issuer to put in place budgetary, tax, or other actions that may eliminate the default or otherwise improve the post-default value of the securities. The market for the defaulted securities will be periodically reviewed by the Corporation and other bank regulatory authorities. Upon determination that a functioning market has been reestablished, depreciation on defaulted municipal general obligations will be classified Loss. During such interim, the book value of all defaulted municipal general obligation securities will be classified Doubtful. No charge-off is required for defaulted municipal general obligation securities while they are classified Doubtful. The above exceptions will not apply in those instances where it is determined that there is no likelihood that the municipality will ultimately be able to repay or satisfactorily restructure its obligations.

Stocks

In those states where corporate stocks may be legally acquired, they will be evaluated and classified on their individual merits. Examiners will find the qualitative ratings provided by recognized investment advisory services to be helpful guides. Exception will not be taken to corporate equities which are well regarded by knowledgeable investors, marketable and held in moderate proportions. Any stock not meeting the above criteria will be considered of subinvestment quality and any excess of book value over market value will be classified Loss, with the remaining book value classified Substandard.

In addition to appraising the investment quality of corporate stocks, examiners should determine that the carrying values of marketable equity securities are adjusted to the lower of aggregate cost or market value on a periodic basic (i.e., quarterly or more frequently). Instructions for the Consolidated Reports of Condition and Income state that any unrealized loss (aggregate cost of portfolio in excess of market value) should be charged directly against the undivided profits account. Subsequent reduction of any unrealized loss should be credited directly to undivided profits. Redeemable preferred stock, also known as limited life preferred stock, is excluded from this accounting treatment because generally accepted accounting principles allow investors to account for this type of stock at amortized cost. Indenture agreements for these types of preferred stocks frequently contain sinking fund requirements.

VII. OTHER SECURITIES ACTIVITIES

Mutual Funds

Banking laws or regulations in many states permit insured state nonmember banks to purchase and hold investment company shares (i.e. Mutual Funds). Bank purchases are usually restricted to investment companies that invest only in instruments in which the bank is permitted to invest directly. Thus, banks would not generally be permitted to invest in investment companies whose assets consist of equity securities (stocks). Limits on the amount a bank may invest in a particular investment company may also be prescribed by state law or regulation and are commonly based on the types of instruments in which the investment company invests. For example, a state may permit a bank to invest without limitation in a mutual fund whose assets consist solely of U.S. Treasury securities. However, a bank's investment in a mutual fund that invests in corporate bonds could be limited to the percentage of bank capital that a bank could invest in a single obligor's corporate bonds. State law might further require that a bank's "pro rata share" of a mutual fund's holdings of instruments issued by an individual obligor, when combined with any other bank loans to or securities issued by this obligor, may not exceed a certain percentage of capital. Shares in investment companies that invest in a particular type of security (for example, U.S. Government agency securities) may not be acceptable on the same basis that a security of that particular type would be for pledging against public funds deposits or for other pledging purposes.

If a bank invests directly in a debt security or money market instrument and has the ability and intent to hold the investment to maturity, such an asset is carried at amortized cost (i.e., cost adjusted for amortization of any premium or accretion of any discount). Unlike a debt security or money market instrument which has a maturity date at which time a bank expects to be repaid the face amount of the instrument, investment company shares have no maturity date even if the mutual fund itself invests in debt securities or money market instruments. The purchaser of shares in a mutual fund can convert the investment into cash only by selling the shares. Moreover, by investing in a mutual fund, a bank does not have the ability to control whether the investments in the mutual fund's portfolio are held to maturity. Thus, for financial reporting purposes, mutual fund shares are to be accounted for as marketable equity securities in accordance with Financial Accounting Standards Board Statement No. 12, "Accounting for Certain Marketable Securities" (FASB 12). Under FASB 12 and as allowed in the Call Report instructions, a bank's holdings of investments in mutual funds (or any other marketable equity securities) should be valued at the lower of their aggregate cost or aggregate market value on the balance sheet.

Because the nature of mutual fund shares differs from that of debt securities and money market instruments, bank investment policies should not treat investments in mutual funds as if they were direct investments in the assets of the mutual fund. Therefore, board of director authorization for mutual fund investments should be included in the bank's investment policy prior to any investment in mutual fund shares. Moreover, the investment policy should clearly state the following:

1. The investment objectives and policies (including the maturities of investments) that a mutual fund should have in order to be an appropriate investment for the bank;

2. That mutual fund investments will be limited to funds in which the shareholders are shielded from personal liability for acts or obligations of the investment company;

3. The maximum individual and aggregate investment that it will make in mutual funds; and

4. In light of a mutual fund's lack of a maturity date and the applicable accounting standards, the maximum net unrealized loss (net depreciation) the bank is willing to absorb before considering whether to continue to hold its mutual fund investments.

Since a net unrealized loss on such investments will adversely affect bank capital, the investment policy should also provide for a review of the market values of mutual fund investments at least monthly. More frequent reviews would be appropriate when interest rates are moving upward or when mutual fund market values are otherwise showing a declining trend. To ensure that the bank's board of directors is fully informed about the accounting procedures governing investments in mutual funds, the investment policy should incorporate an appropriate reference to the applicable accounting standards.

Each mutual fund investment must be evaluated and classified on its own merits, consistent with the guidance contained in the discussion of "stocks" in this section. To the extent that a mutual fund's investment portfolio is comprised of securities and other financial instruments that are of investment quality, the mutual fund should normally be considered of investment quality. However, if a mutual fund's portfolio consists largely of investments that would be deemed subinvestment quality if a bank owned them directly (in general, securities rated below the four highest grades, unrated securities of equivalent quality, and defaulted securities), the mutual fund investment should be considered of subinvestment quality. In this situation, any excess of book value over market value should be classified Loss, with the remaining book value classified Substandard.

When the examination date falls between the bank's periodic valuation dates for investments in mutual funds, an increase in the net depreciation in these investments (plus all other marketable equity securities), if any, since the most recent valuation date is to be classified Loss. However, examiner insistence on immediate charge-off of the Loss classification is not necessary provided the bank periodically charges its net unrealized losses on these investments against its capital in accordance with FASB 12. On the other hand, if the bank has failed to institute procedures for the periodic valuation of its investments in mutual funds, the bank should be instructed to immediately charge off the net unrealized loss (net depreciation) in such investments by establishing the valuation allowance and the corresponding debit balance capital account as prescribed by FASB 12.

Leeway Securities

The FDIC's Board of Directors adopted a statement of policy and guidelines for "Investments in 'Leeway Securities'" (refer to the Prentice-Hall volumes). The FDIC's examination policies were adjusted to enable insured State nonmember banks that so desire to invest in equity or capital debt securities (not including direct loans or discounts) falling within broad categories without fear of criticism by the FDIC or its examiners, but subject to the following conditions: That such investments are allowed for State nonmember banks by applicable State law; that the aggregate total of all such investments not exceed the amount authorized by applicable State law or 10% of the bank's total capital or surplus accounts, exclusive of capital notes and debentures, whichever is less; and that all such investments have been approved by the bank's board of directors or trustees as "leeway securities" and are so identified on the bank's general or subsidiary ledger records. Within the parameters outlined above, the acquisition of "Leeway Securities" will not be subject to criticism by FDIC examiners, and in the absence of default or bankruptcy will be permitted to be carried on the bank's books at amortized acquisition cost.

Repurchase Agreements

A repurchase agreement (repo) is technically defined as the simultaneous purchase and sale of the same security for different settlement dates. An institution which engages in a repurchase agreement agrees to sell a security to a counterparty and simultaneously commits to repurchase the security at a mutually agreed upon future date. In economic terms, a repurchase agreement is a form of secured borrowing, where an institution pledges securities to a counterparty in exchange for cash. From an accounting standpoint, financial institutions can generally treat repurchase agreements as borrowings rather than asset sales. In a reverse repurchase agreement, an institution agrees to purchase a security while simultaneously committing to sell the same security back to the counterparty at a future date. For accounting purposes, reverse repurchase agreements are generally treated as short-term investments, rather than asset purchases.

The vast majority of repurchase agreements mature in three months or less. One-day transactions are known as overnight repos, while transactions longer in duration are referred to as term repos. Institutions typically use repurchase agreements as short-term, relatively low cost, funding mechanisms. Likewise, reverse repos are used as short-term investment alternatives to other money market instruments, such as Federal funds. The interest rate paid on a repurchase agreement depends on the type of underlying collateral. In general, the higher the credit quality of the collateral and the easier the security is to deliver and hold, the lower the repo rate. Supply and demand factors for the underlying collateral also influence the repo rate.

Properly administered repurchase agreements that are conducted within a comprehensive asset/liability management program are not normally subject to regulatory criticism. However, repos that are inadequately controlled may expose an institution to risk of loss and will be regarded as an unsuitable investment practice. Since the market value of the underlying security may change during the term of the transaction, both parties to a repo may experience credit exposure. Although repo market participants normally limit their credit exposure by requiring margin collateral and by regularly marking term transactions to market, there is no substitute for a thorough credit review of repo counterparties prior to the initiation of transactions. Typical margins range from 1 to 3 percent of the trade principal but may be 10 percent or more for illiquid securities.

Many portfolio managers have severely underestimated the credit risk associated with the performance of a counterparty and have failed to adopt the basic safeguards necessary to assure proper control over the underlying securities. Because of the numerous control deficiencies found to be associated with these transactions, the FDIC has established minimum standards for any depository institution engaged in repurchase agreement transactions. Financial institutions that are actively engaged in repurchase transactions should be encouraged to have even more comprehensive controls to suit their particular circumstances.

The risks inherent in repurchase agreement transactions should be controlled by an institution through policy guidelines that at a minimum provide the following:

1. Establish written credit policies;
2. Require identification and periodic credit evaluations of each counterparty;
3. Establish maximum position and exposure limits for each counterparty;
4. Mandate individual or master written agreements for all repurchase transactions that specify acceptable collateral types and maturities, call defaults and sellout provisions, ownership rights, substitute collateral rights, and persons authorized to transact business on behalf of both parties;
5. Provide for acceptable control provisions over underlying securities.

The full text of the policy statement on repurchase agreement transactions can be found in the Prentice-Hall volumes.

Examiners should note that the definitions of repurchase agreement and reverse repurchase agreement as used in this section are applicable to the terminology of the commercial banking industry. In the thrift industry, the terms repurchase agreement and reverse repurchase agreement are given opposite definitions. Thrift institutions refer to borrowings as reverse repos and to short-term investments as repos. To avoid confusion over terminology, examiners should focus on the economic substance of the transactions.

Dollar Repurchase Agreements

Dollar repurchase agreements, also known as dollar repos and dollar rolls, provide financial institutions with an alternative method of borrowing against securities owned. Unlike "standard" repurchase agreements, dollar repos require the buyer to return to the seller substantially similar, versus identical, securities. Dealers typically offer dollar roll financing to institutions as a means of covering short positions in particular securities. Short positions arise when a dealer sells securities that it does not currently own for forward delivery. To avoid the costs associated with failing on a delivery, dealers are willing to offer attractive financing rates in exchange for the use of the institution's securities in covering a short position. Savings associations are the primary participants among financial institutions in dollar roll transactions, and mortgage pass through securities are typically used as the underlying collateral.

Supervisory authorities do not normally take exception to dollar repos, provided that the transactions are conducted for legitimate purposes and the institution has instituted appropriate controls. However, dollar repos that are designed to permanently dispose of securities while circumventing accounting rules for loss recognition will be viewed as an unsuitable investment practice.

To qualify as borrowings, dollar repos must require the buyer to return to the seller "substantially similar" securities by the settlement date, which can not exceed 12 months from the inception of the transaction. Mortgage pass through securities repurchased are considered "substantially similar" to those sold if all of the following conditions are met. The securities must

1. Be collateralized with similar mortgages;
2. Be issued by the same agency and be part of the same program;
3. Have the same remaining weighted average maturity;
4. Be priced to have similar market yields;
5. Have identical coupon rates;
6. Satisfy good delivery requirements.

In addition, securities used in dollar repo transactions must have been held in the seller's investment portfolio for a minimum of 35 consecutive days prior to the initiation of the contract.

Examiners should require appropriate financial statement adjustments in cases where institutions have improperly reported dollar repurchase transactions.

Specified Mortgage Pools

Specified mortgage pool trades differ from TBA transactions in that the pool numbers of the underlying securities are known by the buyer at the time of the trade. In a TBA trade, the price of the underlying securities is computed by assuming that the unidentified pools have "generic" characteristics. The term "generic" refers to the average characteristics for all outstanding pools of a given coupon from the same agency program. The actual characteristics, including prepayment behavior, of any particular pool within a "generic" group may be quite different from the "generic" averages. Therefore, the price of a specified pool is normally computed based on its actual characteristics, instead of generic assumptions.

A primary component of the market value computation for a mortgage pass through security is the prepayment assumption, regardless of whether the instrument is purchased on a TBA or specified basis. Major Wall Street dealers publish long-term prepayment projections for "generic" securities on a periodic basis. The average of the dealers' estimates is known as the market consensus prepayment speed. Due to the extremely large number of individual pools outstanding, no such projections are available on a pool by pool basis. Thus, specified pools tend to be priced off of historical prepayment speeds rather than projected speeds. There is no guarantee, however, that the future rate of prepayment for a specified pool will be similar to the pool's historical prepayment rate.

An undesirable practice sometimes associated with investing in specified pools is the activity of paying significantly more for such securities based on the pools' historical prepayment speeds. In the specified pool market, dealers will offer premium-coupon pass throughs with below average historical prepayment speeds and discount-coupon pass throughs with above average historical prepayment speeds at higher prices than their generic counterparts. Once purchased, if the pools' actual prepayment speeds do not conform to their historical standards but, instead, move toward the long-term generic projected speeds, the investor may not be adequately compensated for the extra cost of the specified pools.

Coupon Stripping

Coupon stripping occurs when a security holder physically detaches unmatured coupons from the principal portion of a security and sells either the detached coupons or ex-coupon security separately. This practice can significantly diminish the worth, marketability, and liquidity of a security and is generally considered inappropriate except on a limited, legitimate scale.

In accounting for such transactions, the original cost, including any unamortized premium or discount, must be allocated between the ex-coupon security and the detached coupons at the time the security is divided in order to establish a basis for determining the carrying value of the portion retained and the gain or loss on the portion sold. This allocation shall be based upon the yield to maturity of the security at the time it was originally purchased. Also, this cost allocation must establish the same yield to maturity for each portion. Detached coupons and ex-coupon securities that are held in an institution's investment portfolio must be reported as "Other Debt Securities" in the examination report. Net gains or losses from the sale of detached coupons or ex-coupon securities shall be reported in "Other Noninterest Income" or "Other Noninterest Expense" as appropriate. The amount of any discount or premium relating to the detached coupons or ex-coupon securities must be amortized to maturity.

Due to changes in IRS regulations, many of the tax benefits formerly associated with coupon stripping have been eliminated. Before the tax law revisions, an institution could delay its tax liability and also be allowed a significant capital loss. Because of the loss of tax revenue, Congress passed the Tax Equity and Fiscal Responsibility Act in 1982, which removed the tax advantages from coupon stripping activities.

Zero coupon, stripped, and Original Issue Discount (OID) products are distinctly different from securities that have all the unmatured coupons attached. Ex-coupon securities have a diminished and uncertain market value and, because they are not considered "good delivery" items by security dealers, there is an impairment of their practical liquidity. National banks may not pledge ex-coupon securities as collateral for their own trust deposits and State banking authorities should be contacted for relevant requirements for State chartered institutions. Such securities require physical custody transfer and cannot be wire transferred on the Federal Reserve Communications Systems. Management should also realize that it is not the general practice of the Federal Reserve System to accept ex-coupon securities as collateral for U. S. Government deposits or borrowings from its banks.

U.S. Treasury obligations are the most common type of securities used for coupon stripping. Corporate or municipal issues may be used but are not viewed as attractive alternatives because of credit risk and early redemption features. Beginning in 1983, all new U. S. Treasury issues were available only in book-entry form. With the conversion to book-entry, the supply of physical Treasury certificates for stripping was greatly diminished.

In response to the lack of availability of physical certificates, several securities firms developed a variation of coupon stripping by issuing proprietary zero-coupon certificates. The dealers create these instruments by purchasing U. S. Treasury securities, delivering these securities to a trustee, and selling receipts representing the rights to future interest and/or principal payments on the U. S. Treasury securities held by the trustee. Such Treasury receipts are not an obligation of the U. S. Government and are to be reported as "Other Debt Securities."

Under a program called Separate Trading of Registered Interest and Principal Securities (STRIPS), the U. S. Treasury has issued certain long-term note and bond issues that are maintained in the book-entry system operated by the Federal Reserve Banks in a manner that permits separate trading and ownership of the interest and principal payments on these issues. Even after the interest or principal portions of U. S. Treasury STRIPS have been separately traded, they remain obligations of the U. S. Government. STRIPS held in the reporting bank's securities portfolio shall be reported as "U. S. Treasury" securities.

Zero coupon, stripped, and certain OID securities are priced at large discounts to their face value prior to maturity and exhibit significant price volatility. Although considered free from credit risk if issued directly by the U. S. Government, longer maturities of zero coupon, stripped, and deep discount OID products (generally, remaining maturities exceeding ten years) have displayed extreme price volatility. Therefore, disproportionately large long-maturity holdings of these instruments, in relation to the total investment portfolio or total capital of the institution, are considered an imprudent investment practice. Such holdings will be subject to criticism by examiners who may seek the orderly disposal of some or all of these securities. Securities slated for disposal must be reported as held-for-sale assets at the lower of cost or market value.

VII. ESTIMATED MARKET VALUE

Examiners should compute market values for all classes of securities on which reliable price quotations are readily available. This computation will always be made for U.S. Government securities and obligations of Federal agencies. It will usually be possible to make such computations for corporate and foreign issues, and often in the case of other classes. However, computation of market values for some classes, such as State, county, and municipal securities frequently involves expenditure of unwarranted time and effort. When the pricing of all issues within one class is impracticable, the examiner may enter in the column headed "Estimated Market Value" the total book value of the class of security involved, but this is appropriate only in those situations where the bank faces no problems in its securities account or is not otherwise burdened with serious asset, liquidity or capital problems. Such instances should be marked with an asterisk and footnoted as follows: "*Estimated at book value." When examiners believe a problem exists in the bank's securities portfolio or the bank is in a weakened and vulnerable condition, it will be their responsibility to obtain current market values or the best estimates available for all issues and to include them in the examination report. Whether a problem exists in the bank's securities portfolio will largely be based on such consideration as maturity distribution, particularly the volume of long-term obligations; the volume of U.S. Government and other general market obligations, as compared with holdings of limited marketability; the amount of short-term issues which could readily be converted into cash with negligible risk of any substantial loss; the extent of any depreciation in U.S. Government, Federal agency and other holdings which are priced; the general level of quality of the bank's holdings; the volume of excess cash reserves; the nature and trends of the bank's deposit liabilities and of its loan demands and commitments; bond market levels and trends, and money rates in general; and whether there is any real possibility that the bank may be forced to sell substantial holdings at losses which would be large in relation to the bank's capital funds.

In all cases, it will be necessary to obtain market values or the best estimates available on subinvestment quality securities and securities held in available for sale and trading categories. It should be noted that the Division of Supervision's Office of Capital Markets can arrange for pricing of obligations which have CUSIP numbers as well as certain issues without CUSIP numbers. Examiners desiring securities prices should contact the Office of Capital Markets. If the number of obligations to be priced is limited (five or less), the description of the securities, including CUSIP number, pool number (if applicable), coupon rate, and maturity date; the date for which the price is requested; and the class of the institution can be provided via telephone. More extensive pricing requests should be forwarded to the Office of Capital Markets via facsimile.

The limitations of market value estimates on large segments of bank portfolio holdings should be recognized. For example, serious difficulties surround the endeavor to estimate the market value of "municipals." These securities are floated by thousands of issuers. Some obligations, particularly those of states, leading cities, and important toll roads, are well known to investors and are traded in a nationwide market; therefore, the information necessary to form a judgment is readily available in the financial press. However, most political subdivisions are small, and information supporting an estimate of the quality of these obligations is often inadequate. To price municipal securities, the following sources are suggested: offering circulars prepared by dealers in securities or bond departments of correspondent banks, individual securities dealers, publications of investment advisory services, or the Division's Office of Capital Markets.

There is no organized market for buying and selling "municipal" securities. Investors make purchases and sales with the aid of brokers and dealers who negotiate each individual transaction. Some news regarding offers or bids for the sale or purchase of individual issues may be found in certain specialized financial publications, but, for the most part, the information pertains to recent offerings and large issues that have a national market. To the extent that quoted yields truly reflect current market conditions, they can be translated to securities of comparable quality and terms. However, this process involves a host of judgments, assumptions, and calculations requiring intimate knowledge of the "municipal" bond market, the quality of the particular securities involved, and their potential market under prevailing conditions. There also exist various mechanical methods of pricing such portfolios, but they are imprecise and imperfect and have only limited value. In the final analysis, there is no substitute for competent professional judgment in determining the market value of a bank's "municipal" securities portfolio.

The significance of estimated current market values of investment quality securities should also be kept in proper perspective and should neither be over nor underemphasized. Estimated current market values are primarily of use as a relative measure of liquidity within the portfolio and are indispensable to an in-depth liquidity analysis. This is reason enough for examiners to encourage bank management to obtain periodic prices of all portfolio holdings from professional sources. Any meaningful report comments or criticisms regarding a bank's liquidity posture at a given point in time are virtually impossible without comprehensive pricing of the securities portfolio.

Apart from liquidity considerations, the current market value of investment quality securities is of secondary importance to the bank supervisor in the context of an "ongoing" bank which has consistently followed sound loan and investment policies. Such banks typically will be free from existing or potential liquidity pressures of such severity as might necessitate massive portfolio liquidation at heavy capital loss or heavy and prolonged borrowings at prohibitive costs to avoid such sales. Those banks ordinarily will be in a position to absorb the effects of changed market conditions and/or adjust to the changed levels in interest rates in an orderly fashion with minimal capital or earnings impact. Herein lies the essential logic and rationale of the FDIC's policy of appraising investment quality securities at adjusted or amortized cost (conventional value), a practice consistently followed by all three Federal regulatory agencies and many State banking authorities since the late 1930's. The policy is fundamentally based on the premise that banks which follow sound investment policies will have sufficient flexibility to adapt to major market changes without much difficulty or with only transitory earnings impact. It also recognizes that bank holdings of investment quality securities are generally acquired with investment intent to produce yields over the life of the investment calculated to provide a reasonable margin of

return over operating costs during that period (a fixed yield that remains unaffected by the vagaries of the market).

Although the conventional value method of appraising investment quality securities applies equally to all banks, it was not intended that banks indiscriminately ignore market or liquidity restraints in their investment programs. Unfortunately, a few banks have done precisely that, and under the illusion that the regulatory authorities' conventional value treatment of investment quality obligations liberated them from the discipline of the market, undertook investment programs which emphasized income above all other consideration. Where such policies were accompanied by aggressive lending practices, the banks found themselves ill-equipped to cope with major and enduring upward movements in the levels of interest rates. Moreover, inasmuch as major upward movements in interest rates are normally accompanied by liquidity pressures on both the asset and liability side of the balance sheet, banks that found themselves in this position were frequently faced with one of two alternatives; either sell portfolio holdings at unacceptable losses or borrow funds (when available) at prohibitive interest rates. It is in such banks that the market value of the securities portfolio assumes critical significance to the bank supervisor. It not only measures the extent of depreciation in the securities account, but also provides a basis for determining whether the bank's problems can be resolved without heavy capital inroads and consequent injection of new capital. It is at such a point that valuation of a securities account on a "liquidation" basis rather than an "ongoing" bank basis becomes appropriate for purposes of determining capital adequacy.

Examiners should be alert to such situations or developing problems of this nature and should not only obtain the best estimates of current market values available on all securities, but should also include sufficient supplemental data in the report to illustrate the full extent of the problem. Supplemental schedules are thus encouraged when they serve a useful purpose.

IX. ACCOUNTING

The FDIC has issued policy statements, directives, and reporting instructions on specific securities' subjects which deserve discussion because they direct the attention of banks and examiners to mandated or acceptable accounting procedures. These subjects include amortization of bond premium, accretion of bond discount, trading account securities, and securities purchased or sold under repurchase agreements or similar transactions.

Premium Amortization and Discount Accretion

Premiums and discounts should be accounted for according to the "Instructions - Reports of Condition and Income." Premiums should be accorded a Loss classification to the extent of any failure to make adequate amortization charges.

FASB Statement No. 115

For call report purposes, all banks must adopt Financial Accounting Standards Board Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities.

Statement No. 115 requires depository institutions to divide their securities holdings among three categories: held-to-maturity, available-for-sale, and trading securities. The accounting standard provides a different accounting treatment for each category. Under Statement No. 115, only those debt securities for which an institution has the positive intent and ability to hold to maturity may be included in the held-to-maturity account, and the institution should account for these debt securities at amortized cost. Securities in the available-for-sale category are defined as those securities for which the institution does not have the positive intent and ability to hold to maturity, yet does not intend to trade actively as part of its trading account.

Trading Account Securities

The business purpose with respect to trading account securities differs from that for investment securities; thus, the accounting treatment is also different. Trading account securities are an inventory of securities, including money market instruments, held for resale to other banks and to the public. These securities may be valued at market or the lower of cost or market. Disclosure regulations require banks to footnote their financial statements to indicate the valuation basis employed. Trading account securities

should not be included within the bank's own investment portfolio but should be reflected as a separate item on the balance sheet in reports of examination, if held in significant amounts. For reporting purposes, banks that only occasionally hold securities purchased for possible resale should include such securities in the investment account.

In recognition of the speculative characteristic and potential of a trading account, market and accounting disciplines are imposed on transfers between the trading account and the investment account. Securities transferred from the investment account to the trading account should be recorded at the lower of book value or market value at the time of the transfer. Market depreciation is thus recognized immediately by a charge to current period earnings, whereas any unrealized gain is deferred until the time of actual sale. Transfers from the trading account to the investment account must be recorded at market value with any loss or gain from the transfer immediately recognized as a trading loss or gain.

At a minimum, the discovery of investment transactions which are more appropriate in a designated trading account will necessitate examiner recommendations to control and possibly register those activities and implement the accounting procedures described above. If the bank's financial condition is unsatisfactory or management lacks the degree of expertise required, such activities should be discontinued.

Securities Purchased or Sold Under Repurchase Agreement or Similar Transactions

Securities held by a bank under a repurchase or similar agreement should not be included in a bank's investment or trading account for such holdings are, in reality, a form of loan. For report of examination purposes, include as "Federal Funds Sold" securities purchased under agreement to resell that involve the receipt of immediately available funds and mature in one business day or roll over under a continuing contract. Agreements which mature in more than one business day should be included in the report of examination as "Securities Purchased Under Agreements to Resell." Similarly, securities sold under such agreements should be reflected in reports of examination under the captions "Federal Funds Purchased" or "Securities Sold Under Agreements to Repurchase" depending on the maturity of the contracts. Such transactions do not require entries to the securities account of either bank. The selling (or borrowing) bank continues to carry the securities in its investment account, collect all interest thereon and make the necessary income adjustments for amortization or accretion, as the case may be. Transactions of this nature which disguise the real intent of the transaction are discussed under Securities Activities.

X. AUDIT

It is the FDIC's policy to encourage an adequate audit program for every insured financial institution and that subject, including fraud detection, is discussed under the Internal Routine and Controls Section of this Manual. However, when examining the securities account and in fulfilling the responsibility of appraising the adequacy of internal and external controls in that area, examiners must perform certain audit procedures and be alert to possible improper investment practices. Required procedures include reviewing security invoices, analyzing security purchases and sales since the last examination, and auditing settlement practices. Time and staffing constraints may restrict complete reviews, but examiners must be reasonably assured that the institution's investment practices are proper.

Invoices

Invoices for bonds sold or purchased by a financial institution should be retained in its files. Examiners will scrutinize invoices to arrive at a basis to establish book value and to determine possible misrepresentation.

Invoice reviews can also determine whether or not (1) the institution engages one securities dealer or salesperson for virtually all transactions; (2) the institution engages "out of territory" dealers or salespeople to an unreasonable extent; (3) investment account securities have been purchased from or sold to the institution's own trading department; (4) the institution is engaging in futures, forwards and standby contracts; (5) an unusual volume of trading activity exists in the investment portfolio; and (6) any other activities are conducted which appear to be outside of the legitimate needs of the institution.

Any of these practices will necessitate thorough discussion with management and comparison of purchase and sale prices to independently established prices as of trade date. These practices may also require cross referencing descriptive details on investment records and purchase confirmations to the actual bonds or safekeeping receipts.

Purchases and Sales

At a minimum, examiner methods of analyzing investment account activity since the previous examination will involve a review of purchases and sales. The bank's record of original entry and supporting schedules will be reviewed to determine actual costs, original carrying value, proper accountability for the proceeds of sales, and correct handling of gains or losses on securities.

Settlement Practices

Review of an institution's settlement practices should focus on internal controls and management's level of knowledge and expertise. Inadequate knowledge of standard settlement practices and/or poor internal controls over purchase and sale transactions can result in unnecessary costs to a financial institution. This section discusses industry accepted settlement practices for various types of securities and describes the possible adverse consequences of failing to adhere to those standards.

U. S. Treasury and Agencies - The vast majority of outstanding U. S. Treasury and Agency obligations are in book-entry form, rather than in the form of a physical certificate. Book-entry is an electronic registration, transfer, and settlement system which enables the rapid and accurate registration and transfer of securities with simultaneous cash settlement. Book-entry reduces the costs and risks of physical handling and speeds the completion of transactions. U. S. Treasury and Agency book-entry securities are delivered and cleared over the Federal Reserve Wire System (Fedwire). The book-entry custody system is maintained by the Federal Reserve Bank of New York. All depository institutions are eligible to maintain book-entry accounts at their local Reserve bank, provided that they also maintain a funds account with their Reserve bank. Wireable securities are settled delivery versus payment (DVP). DVP denotes one simultaneous transaction, delivery of a security and receipt of payment. Acceptance of the security automatically debits the payment amount from the buyer's account and credits it to the seller's account. Both the payment and securities involved are transferred over the Fedwire system. Normal settlement for U. S. Treasury and Agency securities is the next full business day after the trade date.

Corporates and Municipals - Corporate and municipal debt securities are available in book-entry and registered, definitive form. The use of registered bond certificates is on the decline, however, as an increasing number of issues are sold in book-entry form. Book-entry corporate and municipal bonds settle through the Depository Trust Company (DTC). DTC is a cooperative owned by the financial services industry which serves as a national clearinghouse for the settlement of trades in corporate and municipal securities. Members effect securities deliveries through DTC via computerized bookkeeping entries.

Normal settlement for corporate bonds is five full business days after the date of the transaction. Guidelines for the settlement of municipal securities are established by the Municipal Securities Rulemaking Board (MSRB). When examining an institution with a heavy volume of purchase and sale transactions in municipal securities, examiners should consult the MSRB regulations for additional guidance.

Mortgage-Backed and Other Related Securities - The settlement procedures for mortgage-related securities are more complex than those for government, corporate, and municipal bonds. As such, the mortgage-backed securities settlement process presents specific challenges to the trading operations department and can result in unnecessary expenses if not properly controlled.

In an effort to standardize settlement procedures, the Public Securities Association (PSA) has developed the "Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities." The PSA is a national trade association of major dealers in mortgage-related and government sponsored securities that acts as a self-regulatory body for the public securities industry. As the PSA's Uniform Practices are updated frequently, institutions which engage in transactions that involve mortgage pass throughs, Collateralized Mortgage Obligations (CMOs), Real Estate Mortgage Investment Conduits (REMICs), Stripped Mortgage-Backed Securities (SMBSs), and Asset Backed Securities (ABSs) should keep abreast of current industry settlement standards. Uniform Practices are summarized in the following paragraphs.

Mortgage pass through securities guaranteed by the Government National Mortgage Association (GNMA) are available in book-entry and definitive form. While most GNMA securities have been converted to book-entry, some physical certificates still exist. Book-entry GNMA securities settle through the Participants Trust Company (PTC) MBS Depository. Chemical Bank is the transfer agent for GNMA securities.

The Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) both issue SMBSs and CMOs/REMICs in addition to mortgage pass through securities. Since 1985, FNMA and FHLMC securities have been issued in book-entry form only. Nearly all of the agency's securities that were issued in definitive, registered form prior to 1985 have been converted to book-entry. Book-entry securities of FNMA and FHLMC are transferred, delivered, and settled through the Fedwire system.

Private label CMOs/REMICs (those issued by an entity other than FNMA and FHLMC) and Asset Backed Securities are available in book-entry and registered, definitive form. Book-entry private label CMOs/REMICs and ABSs settle through the DTC. Private label pass through securities are only available in physical form.

Confirmation and Delivery Requirements - Mortgage-Backed and Other Related Securities

Within one business day following the trade date, each party in a CMO/REMIC, SMBS, or ABS transaction should send a written confirmation of the transaction to the other party. The confirmation must contain, at a minimum, the CUSIP number; description of the security; confirming party's name and address; designation of "purchase from" and "sale to"; the price, interest rate and original face; the trade date and settlement date; the maturity date; and the settlement amount. Institutions should have procedures established to issue, receive, and verify confirmations in a timely fashion. An institution is bound to a particular trade if it does not object to the written confirmation within 10 days of its receipt. Failure to exercise appropriate controls over confirmation procedures may result in the receipt or delivery of incorrect securities and improper payment amounts.

Confirmation procedures for mortgage pass through securities differ from those for CMOs/REMICs, SMBSs, and ABSs, due to the manner in which mortgage pass through securities typically trade. Most trades of mortgage pools occur on a TBA (To Be Announced) basis. In TBA transactions, information on the mortgage pools, such as pool numbers, is not known at the time of the trade. Instead, the seller notifies the buyer of the pool numbers and original face values of the underlying securities at least 48 hours before delivery. No later than the second business day before the settlement date of each TBA transaction, the seller must transmit the following information to the buyer:

- identification of firm sending the information;
- coupon rate and product;
- trade date and settlement date;
- price;
- pool, group, or other identification number;
- original face for each pool or group number within the transaction;
- issue date and maturity date for new pools.

This information may be transmitted to the buyer verbally or by fax. If agreed to by both parties, the information may also be sent electronically.

The seller must then promptly confirm, in writing, the following information:

- description of the securities, including settlement month, coupon rate, and product type;
- confirming party's name, address, and telephone number;

- identification of the "contra party";
- designation of "purchase from" or "sale to";
- the pool, group, or other identification number;
- the original face for each pool or group number;
- the current face;
- price;
- settlement date;
- amount of accrued interest;
- proceeds to be paid;
- such other information as agreed to by the parties to the transaction.

If the seller does not transmit the required information before the 48 hour deadline, the seller can not make delivery earlier than two business days after such information is transmitted.

The delivery variance permitted on TBA trades is plus or minus 2.50% of the dollar amount of the transaction agreed to by the parties. There is no variance permitted on specified transactions in which the seller provides the buyer with a specific pool number and a specific original face at the time of the trade. The 2.50% variance is applicable to each $1,000,000 within a TBA trade larger than $1,000,000. There is a maximum number of pools that may be delivered to satisfy a TBA trade. For securities with coupon rates below 12%, no more than 3 pools per $1,000,000 may be delivered. Up to 4 pools per $1,000,000 may be delivered for securities with coupons of 12% and above. TBA transactions that do not conform to these guidelines may result in "failed" trades.

Examples of good delivery requirements may be found in the Capital Markets Reference Manual.

The amount payable by the buyer to the seller on the settlement date is known as the settlement amount and is the sum of the principal amount and accrued interest. The PSA formulas for computing the settlement amount can be found in the Capital Markets Reference Manual.

Documentation Required with Delivery - Mortgage-Backed and Other Related Securities

Institutions that purchase and sell mortgage-backed and other related securities in physical form must be aware of the documentation requirements contained in the PSA's Uniform Practices. All physical securities must contain necessary assignments sufficient for their registration in the name of the buyer on the books of the issuer or transfer agent. Each certificate must be accompanied by an assignment on the certificate or separate assignment for each certificate containing a signature that corresponds to the name written on the certificate. A detached assignment (standard corporate bond power) must provide for the irrevocable appointment of an attorney with power of substitution. Also, a detached assignment must include a full description of the security, maturity date, series number, interest rate, and par amount. Each assignment, endorsement, alteration, and erasure must bear a guarantee acceptable to the transfer agent or issuer. A certificate registered in the name of a party other than a natural person will constitute good delivery only if it is accompanied by evidence of the authority of the assignor to transfer such securities.

If a trade has a settlement date between a record date and a payable date, delivery of the securities must be accompanied by a due bill. A due bill is a document delivered by a seller of a security to a buyer evidencing that any principal and interest received by the seller past the record date will be paid to the buyer by the seller upon submission of the due bill for redemption. The record date is the date set by the trustee for determining who will be paid principal and interest on a security. Book-entry messages are considered acceptable due bill substitutes for securities transferred over Fedwire, DTC, or PTC. Due bills and book-entry messages cease to be valid after 60 days from their issuance date. An institution may experience considerable delays in attempting to recover payments without the use of a due bill, which can result in the accumulation of significant principal and interest receivable accounts. If delivery and payment on a trade occur after a record date and on or after a payable date, delivery of the securities must be accompanied by a check for the amount of principal and interest due.

Examiners should verify the existence of sufficient internal controls to ensure that physical and book-entry securities accepted and sent for delivery contain the required documentation or book-entry messages. Generally, the Treasury operations department is assigned the responsibility of ensuring that all incoming and outgoing deliveries meet good delivery guidelines. Examiners should consult directly with operations personnel to review the institution's policies and procedures for good delivery verification. The institution's policies for mortgage-backed and other related securities should conform to the PSA Uniform Practices, and the operations staff should be thoroughly familiar with these industry accepted standards. The frequency and associated cost of failed trades can give the examiner insight as to the quality of the institution's overall settlement practices.

When an institution is on the sell side of a TBA trade, pools must be delivered to the buyer within good delivery guidelines. The process of assigning pools to a TBA transaction is known as allocation. While allocation is a critical part of the settlement process, relatively little effort is normally expended on this function by traders and senior management. Instead, the operations staff is usually responsible for performing allocations. Management should establish independent verification procedures to periodically confirm that the allocations performed by the operations department meet good delivery guidelines. Prudent controls over allocations will reduce the likelihood of costly "fails".

The operations department should also be aware of the PSA Uniform Practices for mortgage-backed and other related securities that govern reclamations. A reclamation is a claim by the buyer for the right to return or a demand by the seller for the return of securities which have been delivered to or accepted by the buyer and for which payment has been made to the delivering seller. A reclamation may be made by either party if information is discovered after delivery, which if known at the time of delivery, would have caused the delivery not to constitute good delivery. Reclamation must be made within the stated time limits established by the PSA.

Settlement Dates - Mortgage-Backed Securities

Unlike corporate and government securities, normal settlement on mortgage pass through securities can be up to 45 to 60 days after the trade date. The PSA designates specific settlement dates each month for various classes of mortgage pass through securities.

Examination Procedures

Examiners should determine the adequacy of the institution's internal controls and management's level of expertise with respect to settlement practices. Minimum internal control procedures should include verification that all incoming and outgoing deliveries meet good delivery standards, timely reviews of confirmations against trade tickets, separation of accounting and trading operations, and policies for resolving discrepancies with counterparties. Management should have a working knowledge of applicable settlement requirements and should provide sufficient staff in the operations department to handle the institution's volume of securities transactions. Weaknesses in the institution's settlement practices should be detailed by examiners on the Internal Routine and Controls schedule and, if necessary, carried forward to the Administration, Supervision and Control page.